

UPDATE ON RESIDENCE AND DOMICILE ISSUES

1. INTRODUCTION

While the review of rules on residence and domicile, underway within HM Revenue & Customs (“HMRC”) and the Treasury for over four years has not (yet) produced firm proposals for reform, there have been several significant developments in the UK principles governing fiscal residence, and for the taxation of foreign domiciliaries living here. The recent case of Mr Robert Gaines-Cooper has occasioned a fair amount of comment in the press, and has caused considerable concern, particularly amongst those who, having previously been established in the UK, have sought to abandon UK residence or domicile or both.

The concern is well founded although the grounds for the decision in Mr Gaines-Cooper’s case were prepared earlier in the year by the decision of the High Court in *Shepherd v Revenue & Customs’ Commissioners*, upholding the finding of Dr Brice, the same Special Commissioner who gave judgement in *Gaines-Cooper*. Nevertheless, the decision introduces further uncertainty particularly as to the degree of reliance that can be put upon HMRC’s published practice, in their well known booklet IR20. It is understood that HMRC do not regard the Gaines-Cooper decision as overturning or invalidating that published practice, and are preparing guidance for a tax bulletin – originally expected before Christmas but now apparently to be deferred until February. Nevertheless, the decision emphasises the desirability of a clear and comprehensive statutory test for determining residence for UK tax purposes. Until then, British and Commonwealth subjects with previously established residence in the UK will find it necessary to demonstrate a fundamental break with this country if they are to be sure of establishing non-residence.

Also during the course of the last year, several important changes have been made, purposely or inadvertently, to the taxation of foreign domiciled individuals resident in the UK. One result of the project to simplify or modernise tax legislation appears to give certain planning opportunities by allowing the basis of taxation to which a foreign domiciled resident is subject to be varied from year to year, thereby allowing for the remittance of prior year income without charge. Whether this change will endure is open to doubt, and there must be a possibility that it will provoke more wide ranging reform of the remittance basis, assuming it continues to be available.

Other changes may particularly affect foreign domiciled residents, enjoying benefits from trusts previously considered as excluded from Inheritance and related taxes. Confusingly, two separate sections 80, one in the Inheritance Tax Act 1984, the other contained in this year’s Finance Act, will expose certain foreign domiciliaries (or their estates) to tax; or at least impose the need formally to make an election before 31 January 2007 if Pre-Owned Asset Tax (“POAT”) is to be avoided (particularly where UK property is beneficially occupied). There is considerable concern that these changes have been introduced without proper notice or consultation, and in the case of the POAT election, may still be unrecognised by many tax payers who are affected. Given the investment by foreigners in the UK property market, it is to be hoped that HMRC will relax some of these requirements by concession or guidance, and that any further changes to the taxation of foreign domiciliaries will be only considered after due and proper consultation and publicity.

Briefing

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2. GAINES-COOPER AND RESIDENCE

Mr Gaines-Cooper is a highly international business man, who was born and brought up in England. The case concerned his claim to have been non-resident since 6 April 1993 (the year after the available accommodation test was thought to have been abolished) and to have established a domicile of choice in the Seychelles sometime around the mid 1970s or thereafter.

It was admitted that during the years under consideration, Mr Gaines-Cooper had spent significant time in the UK, but the appropriate basis of establishing the days of presence in this country was a matter of dispute. Mr Gaines-Cooper had calculated his presence in accordance with the provisions of IR20, ignoring both the days of arrival and departure, together with certain additional days where his presence was necessitated by exceptional circumstances. By contrast HMRC had calculated his presence according to the number of nights spent in the UK.

It was undoubtedly significant that Mr Gaines-Cooper had had a substantial number of trips to the UK where he would spend only the night after his arrival before leaving on the following day. It was also the case that he had maintained a home in the UK, and had substantial personal and social connections with this country. His son had been brought up by Mrs Gaines-Cooper in the UK, in a substantial family home, at least until September 2005 when the son went to school in Switzerland.

The Special Commissioners found that Mr Gaines-Cooper was resident and ordinarily resident throughout the period. The important elements of their decision appear to be twofold. Firstly, that the calculation of presence in the UK should be made on the basis of counting nights spent in the UK – thereby counting as a day's presence visits where the tax payer had arrived on one day and departed on the next. Secondly, the Commissioners decided that, in determining residence, all factors were to be taken into consideration, including the availability of any accommodation. In so doing, they concluded that a different view should be taken of British subjects with a previously established residence in this country from the view taken of those visiting the UK. Only in the latter case was the position to be determined without regard to the availability of accommodation.

This decision certainly has serious implications for British citizens seeking to establish residence abroad, without ensuring that they have significantly transferred their family ties and associations. It has always been good advice to do this, and to ensure, regardless of the 1993 changes, that there should not be available accommodation other than in exceptional circumstances. This would appear to be confirmed by the Gaines-Cooper decision.

In coming to their decision on Mr Gaines-Cooper's domicile, the Commissioners considered it significant that he had connections with the UK, which seemed to go back throughout his life. They found it significant that his will was prepared by English solicitors, he had appointed UK residents as prospective guardians for his son, and furthermore that he retained his British citizenship. While they recognised that he had a substantial home in the Seychelles, nevertheless they found that his principal home remained with his family in the UK. This conclusion on domicile does not perhaps give rise to such concerns, nor have such far reaching effect, as the decision on residence. Mr Gaines-Cooper certainly developed significant connections with the Seychelles, but his presence was measured in weeks rather than in months. In summary, the Commissioners found that, despite his significant ties, the Seychelles had more of a character of a holiday home.

3. DOMICILE - REVIEWING THE SITUATION?

The Government let it be known in March 2002 that it was to undertake a review of the residence and domicile rules affecting individuals, in all likelihood prompted by a desire to react to a concerted campaign in the broadsheet press in the run up to the Budget of that year. April 2003 saw the publication of a somewhat directionless "background paper" on the issue which did little more than summarise the existing rules and compare them with those operated by other countries. Since then, each Budget and Pre-Budget Report has contained an assertion that the review is continuing – until, that is, the Pre-Budget Report of 6 December 2006 which made no reference to it at all.

What conclusions, if any, can be drawn from the recent silence on this issue? The most tempting view is that having considered the impact of a fundamental change to the law in this area, the Government has decided that major reform would be more damaging economically than maintaining the status quo. If this is correct, then the Government could nevertheless defend itself against any charge of inaction by pointing to the following specific measures which it has taken during this period to curb some of the planning opportunities available to foreign domiciliaries:

- Dual contract arrangements – this has been a widely used method of structuring the remuneration package of international executives, perhaps based in London but working for a part of their time abroad. The duties performed abroad are governed by a separate contract of employment with a foreign employer, usually an overseas subsidiary company of the main employer. Provided that all of the duties of the foreign employment are performed outside the UK, the remuneration paid is taxable only on the remittance basis.

The requirement that all duties of the foreign employment (other than incidental duties) be performed outside the UK has always been difficult to satisfy in practice, and increasingly so in an age of laptops, mobile phones and BlackBerrys; and it is probably accurate to observe that HMRC exercised a degree of tolerance towards major city institutions operating this arrangement. This approach finally ceased in April 2005 with the publication of a statement of practice heralding a "change in emphasis" in HMRC's approach to these arrangements. It is now apparent that there will be no tolerance where non-incidental duties of the foreign employment are performed in the UK, and none where the arrangement is essentially a single employment artificially separated into two contractual arrangements. As a consequence of this announcement, many employers have ceased to offer such arrangements altogether. Although the law itself is essentially unchanged, this planning is only likely to be effective in restricted circumstances. This has been an effective initiative by HMRC against a common planning strategy, and was enforced by pressure on the employing institutions.

- Also in 2005, the second Finance Act of that year introduced changes to the CGT rules for determining the location of an asset, so that shares or securities in a UK company would always be regarded as situated in the UK. This change was introduced to prevent planning involving bearer shares or bearer warrants, the situs of which was previously determined by the location of the certificate from time to time. A foreign domiciliary could therefore change the tax situs of, say, his ordinary shares in a UK company by converting them to bearer shares or warrants and arranging for the certificate to be held offshore. The 2005 change prevents such planning.

- Foreign domiciliaries are able to secure long term IHT exemption for non-UK assets by settling them on trust. These assets may then remain outside the scope of UK IHT, even if the settlor later becomes domiciled in the UK. This basic planning has never been available for UK domiciled taxpayers. However, a planning technique developed whereby a UK domiciled taxpayer might purchase an interest in such an “excluded property trust” with a foreign domiciled settlor, thereby exchanging cash fully subject to IHT for an equivalent asset value entirely exempt from IHT. The Government announced provisions in the December 2005 Pre-Budget Report which immediately made this technique ineffective.
- Changes to the status of certain settlements created by foreign domiciliaries have been made with retro-active effect - as a result of amendments to IHT and Pre-Owned Asset Tax in the 2006 Finance Act. These will directly affect some foreign domiciliaries either by exposing them or their trusts to UK tax or requiring elections to be made, thereby imparting information to the UK Revenue. These issues are discussed in sections 4 and 5 below.

It is likely that the omission of any reference to a continuing review of residence and domicile will be noted in the Press, and may be interpreted as an abandonment by the Government of its stated principles. This view, however, does not take account of the actions already taken to curtail more provocative planning. While it is proper for the Government to target artificial tax avoidance techniques, it is to be hoped that it will continue to recognise the vital contribution of the foreign community to the UK economy and the danger that certain piecemeal changes may erode confidence in the stability of the tax regime.

Moreover, the Revenue’s success in the Gaines-Cooper case may indicate that they have concluded that there is sufficient opportunity for tax revenues to be generated through more forceful arguments against claims to foreign domicile based on the existing law.

4. THE REMITTANCE BASIS OF TAXATION

For Income Tax purposes the remittance basis of taxation applies in respect of most types of income arising overseas to:

- Foreign domiciled individuals, or
- Individuals who are not ordinarily UK resident.

It means that the eligible individual is only taxable on this income if he or she remits the funds into the UK. This is in contrast to the arising basis of taxation where the individual is taxable on all income as it arises. UK resident but foreign domiciled individuals are taxable on UK income on the arising basis.

Before 6 April 2005 it was not always necessary to make a claim to be taxable on the remittance basis. The remittance basis of taxation followed naturally from the taxpayer’s foreign domicile (or from being not ordinarily UK resident). Where a notice of return had not been issued, foreign income might go unnoticed and the taxpayer’s status only questioned on enquiry. This changed from 6 April 2005 as the result of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA) coming into force. ITTOIA was produced by the Tax Law Rewrite Team and is a consolidating piece of legislation, which was not intended to make significant changes to tax law. ITTOIA, however, appears to have done so in section 831 which specifies that eligible individuals who want to be taxed on certain “relevant foreign income” on the remittance basis must submit annual claims where the remittance basis is relied upon to restrict their Income Tax liability. If no claim is made

the individuals are automatically assessed on their overseas income on the arising basis. This applies whether the individual has been served with a Tax Return or not. “Relevant foreign income” comprises, broadly, income from a trade profession or vocation and various categories of savings income. It does not include employment earnings.

It is possible to claim for the remittance basis one year and not in the second year and so on. The ability not to claim in one year, thereby accepting liability to tax on the arising basis could provide a tax saving opportunity for those with significant accumulated income arising in earlier years and not remitted.

By way of example, let us suppose a foreign domiciled individual’s only source of overseas income is rent from an overseas property of £100,000 per annum. Assume that for the previous ten years the income has been paid into an offshore account (with the interest being paid to a different non-interest bearing offshore account) and so in 2006/07 the account contains £1.1 million. If in 2006/07 the individual decided not to claim the remittance basis the entire £1.1 million could be brought into the UK with only the £100,000 of income arising in the tax year being subject to Income Tax. If a claim for the remittance basis had been made the full £1.1 million remitted would have been subject to UK tax. By deciding not to make the election the individual will have significantly reduced his tax liability, while remitting the stockpiled income and only paying UK tax on his income in the current year.

Where an individual has more than one source of foreign income, and a claim for the remittance basis is not made, all income arising in the year will be subject to UK tax. It will be necessary to evaluate the tax saving opportunity against the UK tax liability which will arise. Furthermore, preparing the Return on the arising basis will automatically provide HMRC with significant information about an individual’s overseas income and therefore his or her overseas assets, which would not otherwise be disclosed, except possibly where there is an enquiry.

Some commentators have suggested that it may be possible to elect for different treatment in respect of different sources of “relevant foreign income”. This does not seem clearly supported by the legislation, whereas the ability to claim or not in respect of “relevant foreign income” as a whole does. It remains to be seen, however, whether amending legislation will be introduced – possibly retroactively for the current tax year – in the Finance Bill, and taxpayers should proceed with caution.

The ITTOIA provisions do not affect employment earnings or capital gains, where the remittance basis continues to apply to such foreign income and gains automatically.

It does not appear that this change has affected the “ceasing source rule”, whereby income can be remitted to the UK free of tax provided it relates to a source which ceased before the start of the tax year of remittance.

5. SECTION 80 IHTA AND EXCLUDED PROPERTY TRUSTS

The sweeping and controversial changes to the IHT treatment of trusts announced in FA 2006 did not disturb the basic principle that non-UK assets held on trusts settled by foreign domiciliaries enjoy long term IHT exemption as “excluded property”. Although foreign domiciliaries were thus not the intended targets of this reform, the new legislation has altered the way in which one existing anti-avoidance provision applies so that it can now adversely affect the duration of the excluded property provisions in certain circumstances.

A special anti-avoidance provision applied where an excluded property trust provided for an initial life interest for the settlor

or the settlor's spouse and subsequently became held on discretionary terms. In this situation, the legislation deems a new trust to have come into being when the initial life interests of the settlor or the settlor's wife (whichever interest expired last) comes to an end and the trust becomes "relevant property", (which before FA 2006 meant trusts subject to discretionary terms rather than life interest). Where these circumstances arose, the trust would only continue to be regarded as excluded if the settlor or his wife, was foreign domiciled on the expiry of the later life interest if the trust was subsequently being held on discretionary terms. It should be remembered that for IHT purposes (only), an individual is automatically regarded as domiciled in the UK if resident in the UK in seventeen of the last twenty tax years. Where trusts provided for such immediate life interests, the conventional way to avoid this "domicile re-test" was to ensure that after the expiry of the initial life interests, the trust remained subject to life interest terms, generally for future generations and never became subject to discretionary terms.

The principal feature of the FA 2006 reforms was to align the treatment of life interest trusts with "relevant property" trusts so that most trusts would be treated in the same way. This fundamental change has had an unfortunate collateral effect on the application of the anti-avoidance provision described above. Following FA 2006, on expiry of the initial life interests of the settlor and spouse, the trust assets would become "relevant property", irrespective of whether the trust continues to provide life interests for the next generation or becomes subject to discretionary terms. Those who were planning to avoid the "domicile re-test" by ensuring that the trust would remain subject to successive life interests will now need to review the position rapidly.

If the settlor or settlor's spouse, (whoever holds the current interest), is still non-domiciled for IHT purposes, the issue could be dealt with (if the trust deed permits it) by terminating the life interest in favour of a short discretionary period. This would trigger the domicile re-test immediately, when there will be confidence that the individual's foreign domicile will secure that the trust will remain IHT exempt as excluded property.

If, however, the settlor and spouse are already domiciled in the UK, crystallising the domicile re-test prematurely should clearly be avoided. On expiry of the life interests of settlor and spouse, there would be no IHT charge on death since the excluded property exemption would protect the non-UK assets on that occasion. However, the trust would then become fully subject to the decennial and periodic IHT charging regime and it may therefore be worthwhile to consider appointing the assets out to beneficiaries at that stage.

It should be emphasised that this is only an issue for excluded property trusts which provided for an initial life interest for the settlor or spouse. Many excluded property trusts which provide for a life interest for the settlor will have commenced with a brief period on discretionary terms before a life interest was appointed, and these are unaffected by the above changes, but may be subject to the effect of those described below.

6. POAT AND SECTION 80 FA 2006

Section 80 was introduced to block a loophole in the Pre-Owned Asset Tax ("POAT") provisions and was designed to ensure that the Reverter to Settlor Exemption could not be used to avoid the POAT charge. Unfortunately the legislation was drafted widely, and so will catch trusts other than those originally announced as targets. Concern has been expressed as to the unforeseen, and unappreciated, scope of these changes, but HMRC have so far broadly confirmed the wide

application of the provisions. A further concern arises from the fact that the provisions were introduced as at 5 December 2005 and therefore affect Tax Returns for the 2006 tax year due for filing by 31 January 2007.

The legislation disapplies two important exemptions to the POAT charge. Normally, if assets form part of an individual's estate for IHT, or are treated as part of his estate because they were subject to a reservation of benefit, the POAT charge does not apply. However, where the circumstances fall within s80, these two exemptions are not automatically available, and it is necessary to make a specific election for the gift with reservation provisions to apply in order to avoid the POAT charge.

These changes will affect individuals with Pre-Budget Interest In Possession trusts (those treated as forming part of the life tenant's estate) where either the property subject to the life tenancy had previously left his estate or he had directly or indirectly funded the trust's acquisition of that property.

The principal circumstance where s80 will apply is that of a trust in which the settlor did not have an immediate life interest – say it was a settlement for his family on either discretionary or life interest terms - but where he subsequently acquired a life interest prior to Budget Day 2006.

As will be appreciated, the legislation has a retroactive impact in that it affects arrangements already in place. It will particularly affect trusts set up initially as discretionary excluded property settlements by foreign domiciliaries which hold UK property directly or indirectly, and over which interests in possession have come to be granted formally or de facto.

To avoid the POAT charge, an election must be made by 31 January 2007 for the property to be treated as part of the individual's estate for Inheritance Tax purposes. The appropriate form for this election is the IHT500, and tax payers, particularly those beneficially occupying UK property through excluded property settlements, will need to consider their position and take appropriate advice before the filing deadline.

The information contained in this bulletin does not constitute advice and is intended solely to provide the reader with an outline of the provisions. It is not a substitute for specialist advice in respect of individual situations.

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